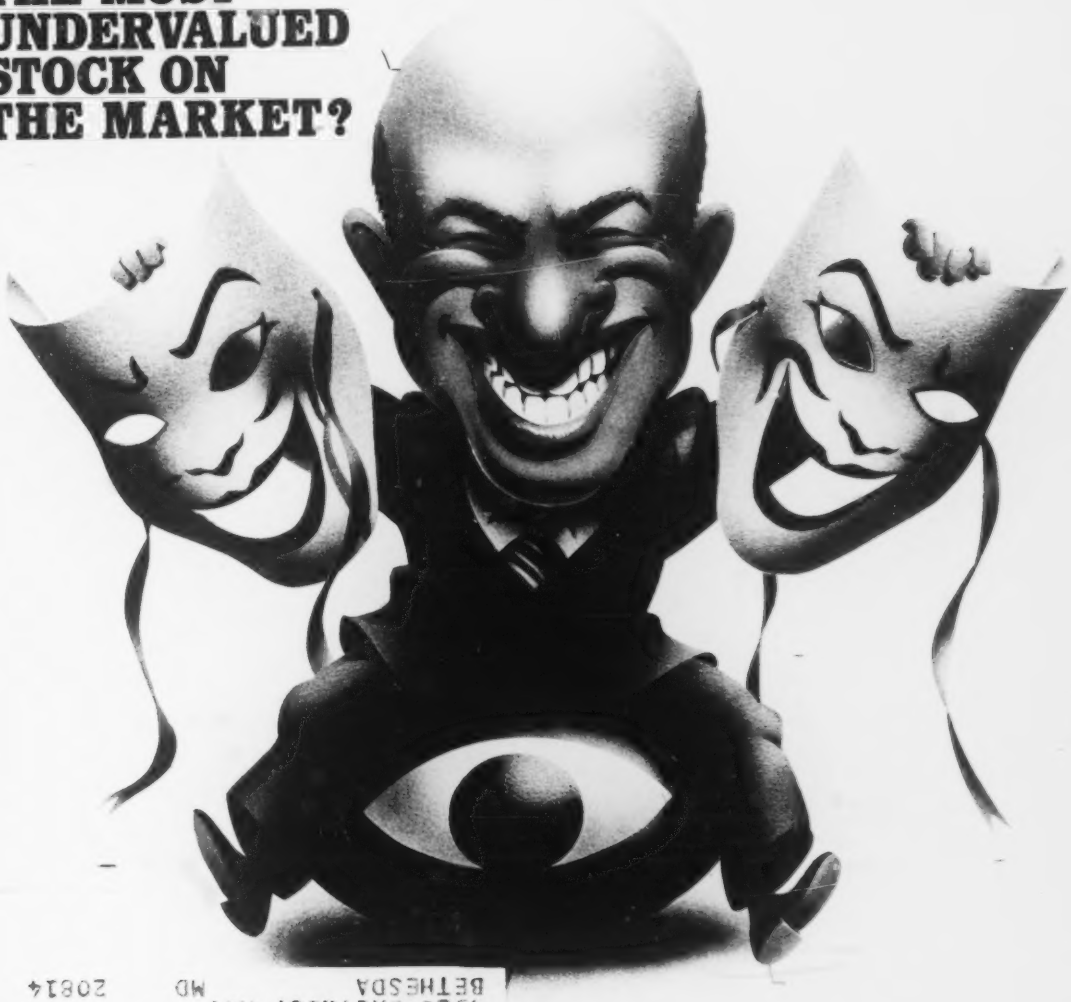
THE COMEBACK IN CHEMICALS — THIS UPTURN HAS STAYING POWER

NEW GROWTH PROSPECTS FOR AN OLD STAPLE — HEROIN

Forbes

LARRY TISCH'S CBS

THE MOST UNDERVALUED STOCK ON THE MARKET?



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Forbes

Cover illustration by Gary Hallgren

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VOLUME 142
NUMBER 3

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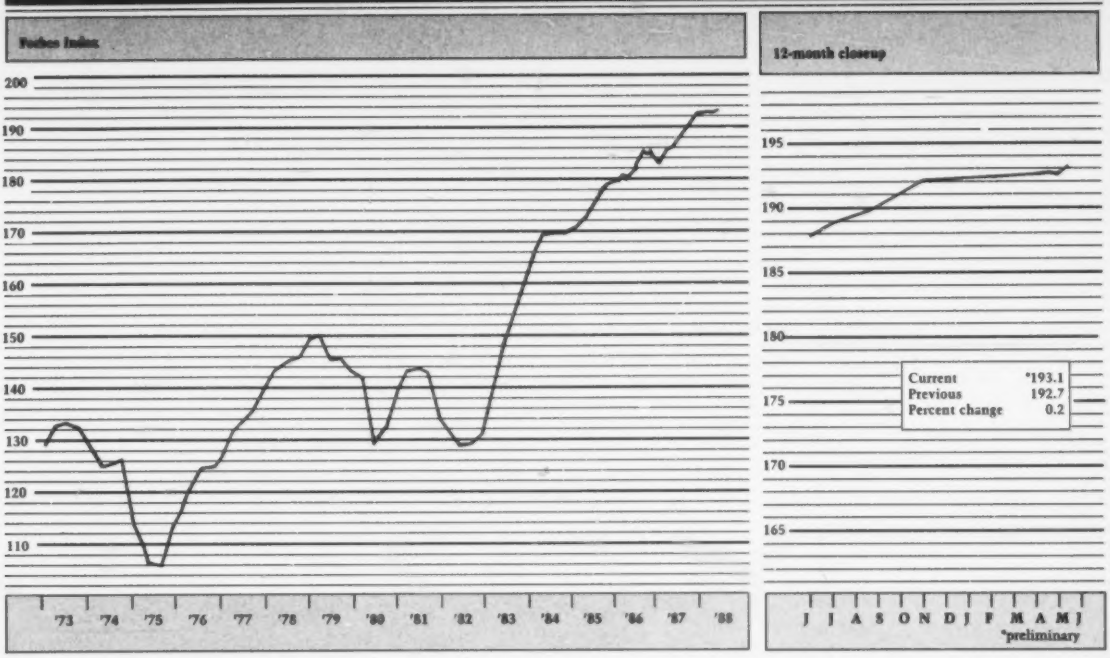
The Forbes Index

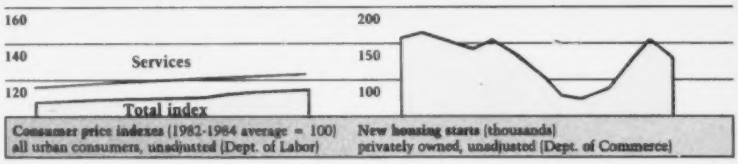


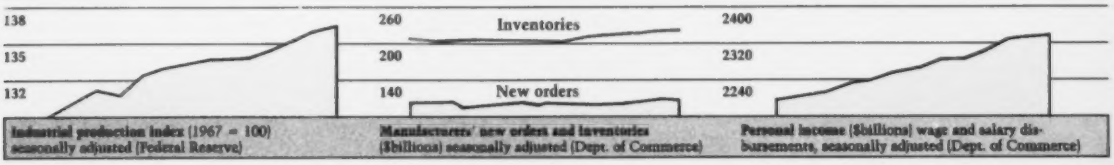
Do we really want a strong dollar? American manufacturers have been reaping the benefits of a relatively strong domestic economy and an improving export market. But things could get tougher in the months ahead if the dollar continues to strengthen. For the moment the economy seems healthy. New claims for unemployment benefits declined in June to their lowest monthly total since last November. The 5.3% unemployment rate recorded in June was the best figure in 14 years, and it may be hard to beat. That's because of rising interest rates and pressure from organized labor for a minimum wage increase. Industrial production rose 0.4% in June and stands 2% above its level at the beginning of the year. Consumer installment credit hit a record $636 billion in May.

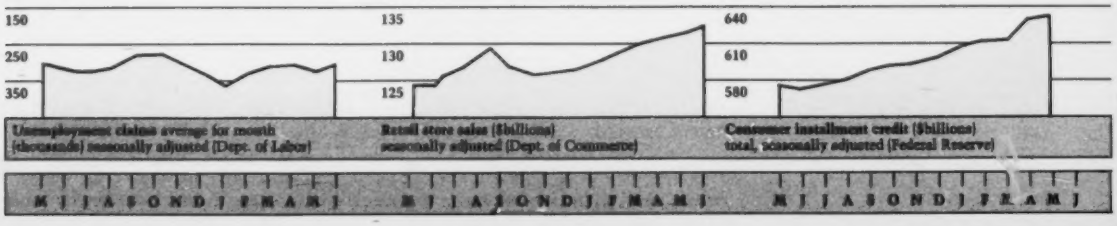
The Forbes Index Components

The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.






150
250
350
Unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)
135
130
125
Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)
640
610
580
Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)
M J J A S O N D J F M A M J
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Fire at Shell's Norco, La. ethylene plant
Making an ethylene-tight market even tighter.

McCusker-Times-Picayune/NPA

Chemical industry assets are changing hands at much higher valuations than what the stock market says the companies are worth. What gives?

Good chemistry

By Howard Rudnitsky

In June General Electric shelled out over $2 billion for Borg-Warner's engineered plastics subsidiary. That priced the company at about 12 times its free cash flow—its cash flow after capital expenditures. Around the same time, some Koppers Co. executives and Gordon Cain, now of Sterling Group, took Koppers' chemicals business private for $660 million, around 10 times the assets' free cash flow.

These are hefty prices to pay in a highly cyclical industry, but they seem to represent a trend. Earlier this year Occidental Petroleum's Armand Hammer paid $1.25 billion for Gordon Cain's $1.2 billion (estimated revenues) Cain Chemical; Oxy also assumed $830 million of Cain's debt. Gordon Cain, 76, started the company only last year and pocketed around a $100 million profit on a $2 million investment.

Why are chemical producers changing hands, often at multiples well above those of publicly traded chemical stocks? Basically because managements believe commodity chemicals are an attractive business, and the cyclical industry seems set for a longer up cycle than expected.

"Things are tight right now in a number of chemical products," reports Dow Chemical Chief Executive Officer Frank Popoff. "The industry clearly needs more capacity, because demand is growing as fast as supply." Popoff's company could earn a record $2.1 billion—$12 a share. In 1984 Dow earned just $524 million—$2.70 a share.

As the chart *(see p. 38)* shows, commodity chemicals' costs have fallen, while prices have recovered smartly from the early 1980s. Back then a combination of inflated energy prices, substantial new capacity and a deep recession all combined to cut chemical company earnings by as much as 80% from their peak earning levels.

Now the earnings have recovered smartly. This is usually the time for huge overbuilding, new price-cutting and another cyclical downturn. Indeed, there has been a spate of capacity addition announcements through 1991: capacity growth of 20% for

Basic chemistry

Earnings for commodity chemicals are near record levels. Stock prices are up, but many chemical stocks still trade at sizable discounts to earnings and cash flow, relative to the rest of the market.

Company	Revenue 1987 ($mil)	Market value ($mil)	EPS 1987	Est EPS 1988[1]	Est P/E 1988	Est cash flow per share[1]	Est price/ cash flow 1988	Price as of 7/15/88	52-week range high–low	Recent yield
MAJORS										
Dow Chemical	$13,377	$17,241	$6.47[2]	$12.00	7.5	$17.25	5.2	90⅛	110–60	3.1%
Du Pont	30,468	21,313	7.39	9.25	9.6	20.60	4.3	89¼	131–75	4.2
Imperial Chemical	18,242	12,243	8.50	9.75	7.5	14.94	4.9	72⅞	108–67	5.5
Monsanto	7,639	6,443	5.63	8.30	10.8	17.72	5.1	90⅛	100–57	3.3
Union Carbide	6,914	3,263	2.16[2]	4.50	5.4	8.48	2.9	24⅜	33–16	3.2[3]
OTHERS										
Aristech	919	877	2.71	5.60	6.1	6.69	5.1	34	39–17	2.3
Georgia Gulf	707	975	6.30	12.00	6.2	13.22	5.6	73⅞	76–28	1.6
BF Goodrich	2,168	1,320	3.17[2]	6.10	8.7	10.94	4.8	53	65–28	3.2
Himont	1,165	2,738	3.77	5.00	8.4	5.94	7.1	42	54–23	2.8
Quantum	2,567	2,639	4.38[2]	13.50	7.5	21.35	4.8	101½	105–49	2.1
Vista Chemical	609	609	2.60[2]	7.50	7.9	10.56	5.6	59¼	61–20	0.8

[1]Source: Mabon, Nugent. [2]Excludes extraordinary gain or loss. [3]Based on quarterly dividend of 20 cents, effective 9/1/88.

polyethylene, 19% for polyvinyl chloride and 9% for polystyrene. Recently Phillips Petroleum announced it will spend $350 million for a 1.5-billion-pound ethylene expansion, to come on stream sometime in 1990.

But don't take all these announcements literally. Says Gordon Cain: "Don't believe everything you hear." Cain believes that some of the announcements are intended to discourage competitors from expanding, rather than to represent firm plans.

Dow's Popoff agrees. "A number of those plant expansion announcements are preemptive strategies. The companies figure if they announce first, maybe the other guy'll think twice [about adding capacity]."

Popoff is backing his optimism about continued strong prices with plans to invest several billion dollars to expand Dow's polyethylene and ethylene capacity by nearly 1 billion pounds each a year over the next five years. Is he bluffing? Unlikely. The capacity Popoff is prepared to add is supported by Dow's extraordinarily high operating rates in those two chemicals.

Morgan Stanley's chemical analyst Paul Leming suggests that the current period is more like the early 1970s than the early 1980s. "In the Seventies," he recalls, "the industry ran at very tight operating rates as a result of prolonged underinvestment in new capacity. It took three years for capacity additions to reduce high operating rates. The same conditions exist today. I feel it's unlikely the industry will move out of the current tight operating environment before 1991."

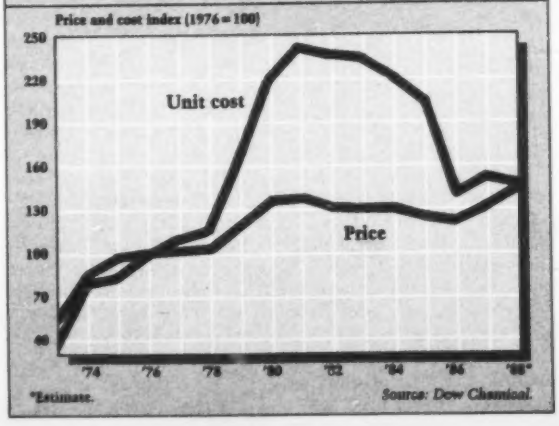
Leming adds: "I'm convinced that profits will hold up better in the next downturn than most investors believe, and that the stocks should be less vulnerable [to a recession] than the market as a whole."

Another analyst, Robert Reitzes of Mabon, Nugent, believes that most commodity chemicals should run at 90% and higher capacity levels through 1990—assuming, of course, no major recession and no major price increases in oil feedstocks. That would be high enough, says Reitzes, "to generate attractive pretax profit margins of 25% to 40%." Back in the bad old early 1980s, margins on many basic chemicals had shrunk to 10%.

There are pessimists as well as optimists, however. Among the former is George Krug of Eberstadt Fleming. Says Krug: "Prices of commodity chemicals have climbed so high that customers will soon begin to substitute other commodities. Then added capacity will put further pressure on prices, which will in turn erode earnings." Enough people agree with Krug that many chemical company shares today sell at large discounts from the price/earnings ratio of the Standard & Poor's 400-stock average. Among the cheapest in terms of earnings are Dow Chemical, Imperial Chemical, Union Carbide, Georgia Gulf, Aristech and Quantum. The stock market, in short, is discounting a downturn in profits, and an upturn in capacity, that may not come for some time. ■

Double leverage

Escalating energy prices and massive overcapacity eroded the chemical industry's profit margins through much of the past decade, as shown by these figures compiled by Dow Chemical. Now, with energy costs lower and with little excess capacity, prices and margins are rising.



and the Caribbean. In Singapore, the BBC can be heard on FM.

U.S. Armed Forces Radio & Television Service, which carries American network newscasts, is scheduled to end 47 years of shortwave service on Oct. 1. In its place, however, will be satellite feeds to low-power AM transmitters near U.S. military installations. AFRTS, therefore, will reach AM radios in places like West Germany, southern Italy, Japan, Korea, the Philippines and Panama. Unlike shortwave, however, these AM signals are stronger during daytime, when the transmitters operate with higher power.—**William P. Barrett**

Sotheby's Art Market Trends

Index sectors	June 1988	One month ago	One year ago	Two years ago	Five years ago	One month % change	One year % change	Two years % change	Five years % change	Five years average annual % change
Old Master paintings	373	373	346	303	212	nil	+7.8	+23.1	+75.9	+12.0
19th-century European paintings	347	347	303	251	185	nil	+14.5	+38.2	+87.6	+13.4
Impressionist & Post-impressionist art	1,091	1,091	521	380	275	nil	+109.4	+187.1	+296.7	+31.7
Modern paintings (1900-1950)	1,090	1,090	544	364	266	nil	+100.4	+199.5	+309.8	+32.6
Contemporary art (1945 onward)	728	728	597	524	366	nil	+21.9	+38.9	+98.9	+14.7
American paintings (1800–pre-WWII)	958	958	789	687	501	nil	+21.4	+39.4	+91.2	+13.8
Continental ceramics	407	407	320	290	272	nil	+27.2	+40.3	+49.6	+ 8.4
Chinese ceramics	684	684	550	493	445	nil	+24.4	+38.7	+53.7	+ 9.0
English silver	388	388	349	314	219	nil	+11.2	+23.6	+77.2	+12.1
Continental silver	260	260	201	190	156	nil	+29.4	+36.8	+66.7	+10.8
American furniture	469	469	451	333	239	nil	+ 4.0	+40.8	+96.2	+14.4
French & Continental furniture	355	355	319	285	249	nil	+11.3	+24.6	+42.6	+ 7.4
English furniture	720	720	594	447	282	nil	+21.2	+61.1	+155.3	+20.6
Aggregate index*	650	650	435	351	265	nil	+49.4	+85.2	+145.3	+19.7

©Sotheby's 1988

Basis: 1975 = 100 ($).
*Contemporary art was added to the Art Index in September 1987. The aggregate index excludes this category prior to that date.
Sotheby's Art Market Trends reflect subjective analyses and opinions of Sotheby's art experts, based on auction sales and other information deemed relevant. Nothing in Sotheby's Art Market Trends is intended as investment advice or as a prediction or guarantee of future performance or otherwise.

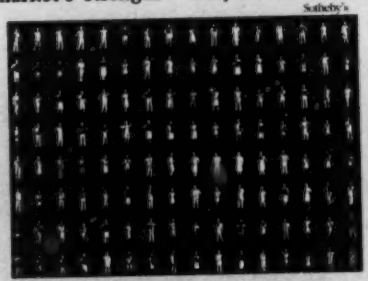
Index highlights

The latest series of Impressionist and Modern painting auctions held in London in June continued the pattern of record-breaking prices seen in New York during the May sales in this sector. Claude Monet's painting of his wife in a field, *Dans la prairie*, surged to $24.3 million, almost four times the previous auction record for a Monet. It was the third most expensive painting ever sold at auction.

One factor contributing to the market's strength may have been the recent rally of the dollar, which was sufficiently strong to encourage American buyers, yet apparently not strong enough to deter the other main participants—Japanese and European buyers—who continued to be active bidders.

Several auctions took place in Monaco, with mixed results. Within the sales of Old Master and 19th-century European paintings, one session produced $7.4 million with 24% unsold, while another resulted in $2 million with as much as 43% unsold.

The furniture sales in Monaco were also uneven, with a number of high prices seen, but also a relatively high number of items unsold. Interestingly, the French government exercised its right and preempted one lot immediately after the sale, stating that it would pay the price realized. The government can use this compulsory purchase system to ensure that a work of art considered to be of national importance stays in the country, while also allowing the seller to receive full market value.



Sotheby's

Fundamental Lexicon, *by Soviet artist Grisha Bruskin, auctioned in Moscow*

Monthly highlights

The first international art auction in Soviet history took place in Moscow July 7. The auction included 119 paintings by contemporary Soviet artists as well as early 20th-century works of the Russian avant-garde. The artwork, bought by Europeans and Americans, many of whom had flown to Moscow for the event, sold for a total of $3.6 million, more than triple the presale estimate.

Numbers Game

Defense contractors face a multibillion-dollar profit pinch from Congress.

Cash now?

Chas. B. Slackman

By Penelope Wang

A TAX LAW CHANGE now wending its way through Congress is likely to cost America's top ten defense contractors billions of dollars over the next five years. It also threatens hundreds of small construction companies.

The change, which could take effect as early as this year, would completely stop companies from deferring taxes on profits earned on multiyear contracts. Under an earlier accounting standard, in force until two years ago, all companies with long-term contracts could defer taxes until the contract was completed. The reasoning behind this "completed contract" method: Most contractors incur high costs and reap scant profits until a project nears completion, so in theory the rule protected them from paying taxes on nonexistent income. But deferred taxes snowballed, particularly in the defense industry.

Though some defense contracts, especially those for major weapons systems, sometimes remain open for 15 or 20 years, many of them begin generating income after, say, 8 years. Thus some major contractors, such as General Dynamics, paid little or no taxes between 1975 and 1985. That triggered provisions to the Tax Reform Act of 1986 and a later amendment in 1987. Those changes forced companies in most cases to adopt a "percentage of completion method," paying an estimated tax on the percentage of the project completed, based on costs incurred. Thus, if a contractor spent 10% of its budget for a new weapons system, the contractor would pay taxes on 10% of the estimated income from the project. The tax bonanza from such a change: an estimated $12.2 billion in added revenues over a five-year period.

Now comes the final assault. The House Ways & Means Committee, led by Representative Dan Rostenkowski (D–Ill.), last month approved a further restriction that would totally eliminate the completed-contract method, raising a further $2.4 billion in tax revenues over three years. The new provision is expected to reach the House floor soon, where it will likely pass. The provision will probably meet some stiff opposition in the Senate. But with many defense contractors accused of paying bribes to win lucrative Pentagon contracts, sympathy votes will be hard to come by.

The potential damage is big. According to Howard A. Rubel, aerospace analyst at C.J. Lawrence, the ten major aerospace firms have amassed a deferred tax liability of $8.3 billion. The new accounting change, coupled with earlier changes and the fact that many contracts are expiring, means about 80% of that tax bill—or $6.6 billion—will come due by 1993. Yet cash on hand for those ten companies amounts to only $5.6 billion.

The outlook is especially bleak for highly leveraged companies. McDonnell Douglas, for example, has a $1 billion deferred tax liability, a $1.6 billion debt load and a cash kitty of only $53 million. Comments Rubel: "You're hard-pressed to see how they'll do anything with shareholders' money but pay Uncle Sam back taxes." Two other relatively highly leveraged defense contractors: Lockheed and Grumman *(see table)*.

The last thing defense contractors needed was another problem. But that's what they've got.

Also affected will be the construction industry, which regularly defers huge tax bills on long-term contracts. Smaller concerns will be at a special disadvantage because they generally have limited working capital and little borrowing capacity.

To hear the construction association tell it, small building firms have been unfairly snagged in the tax net set for defense contractors. Denton Hammond, construction industry expert at the national accounting firm Grant Thornton, agrees. "Construction firms have not been the ones deferring profits for years," he says, noting that the average construction project lasts only nine months. Moreover, each project entails unique costs, whereas many defense contracts are renewals. "By the 200th fighter jet, you know what your costs and profits are," says Michael Repass, senior manager at Price Waterhouse. "But a builder doesn't really know a bridge will be profitable until it's completed."

The construction lobby is still fighting to keep the completed-contract method of deferring taxes. But Congress seems unlikely to listen. ■

Trouble on three fronts

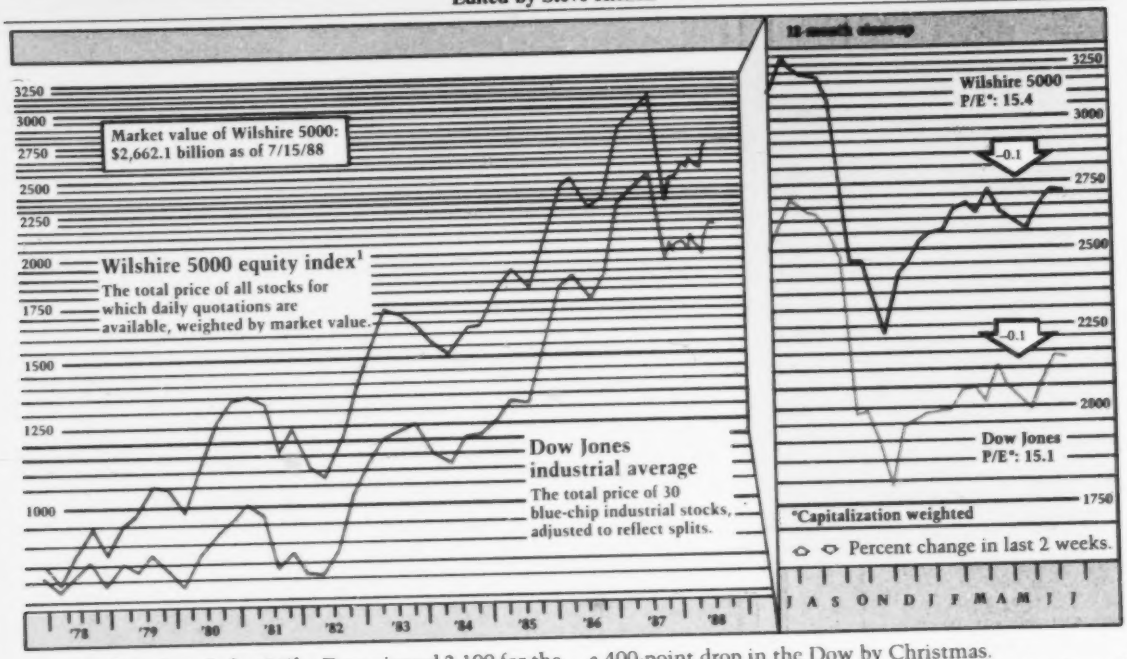
As Pentagon spending began to slow in 1987 many of the ten biggest defense contractors saw their debt increase and cash dry up. Now, deferred taxes are coming due, too.

Company	Cash on hand*	Deferred taxes*	Debt/equity ratio (%)
McDonnell Douglas	$53	$1,027	53.6%
General Dynamics	178	927	26.7
General Electric	1,834	3,720	34.0
Lockheed	40	1,147	59.4
General Motors/Hughes	731	638	10.3
Raytheon	90	275	26.8
Martin Marietta	154	541	38.8
United Technologies	424	302	55.9
Boeing	3,435	1,447	5.4
Grumman	138	114	100.6

Figures as of 12/31/87. *$Millions.
Sources: Company reports; C.J. Lawrence; Prudential-Bache.

The Forbes/Wilshire 5000 Review

Edited by Steve Kichen


Market value of Wilshire 5000: $2,662.1 billion as of 7/15/88
Wilshire 5000 equity index[1]
The total price of all stocks for which daily quotations are available, weighted by market value.
Dow Jones industrial average
The total price of 30 blue-chip industrial stocks, adjusted to reflect splits.
12-month closeup
Wilshire 5000 P/E*: 15.4
Dow Jones P/E*: 15.1
-0.1
-0.1
*Capitalization weighted
Percent change in last 2 weeks.
J A S O N D J F M A M J J
'78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88

Have we been here before? The Dow pierced 2,100 for the first time in late January 1987, on its way to a peak of 2,700. Eighteen months later the Dow is again hovering around 2,100. Someone buying today is perhaps looking for a second climb up to 2,700. But a contrary view is well argued by G. Stanley Berge, a managing director at Tucker Anthony & R.L. Day: "The slowdown in the growth of money, the fragile banking system and the ever increasing debt burden cannot go on for much longer." Berge predicts a 400-point drop in the Dow by Christmas.

A 37-point rally during the final three trading days of the two weeks ended July 15 left the Dow with a 0.1% loss. The overall market as measured by the Wilshire 5000 also fell 0.1%. The Nasdaq composite of 4,635 stocks was unchanged. Year to date, however, the smaller o-t-c stocks continue to outdistance the larger-capitalization companies. The Nasdaq is up 19.4%, versus a gain of only 9.8% for the Dow and 10.4% for the Forbes Sales 500.

Closeup On the Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[2]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	0.7	0.6	1.2	0.5	1.2	2.0
in last 52 weeks	–12.4	–13.0	–15.2	–13.0	–12.5	–9.1

Stock performance based on six key investor yardsticks

Percent change	Company size		Volatility[3]		P/E multiple		Dividend yield		Growth profile[4]		Share price	
	large	small	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	0.3	4.1	3.6	1.8	1.1	2.8	2.2	4.6	5.4	1.6	0.7	2.1
in last 52 weeks	–7.6	16.4	19.3	4.5	–4.0	0.2	0.6	22.2	18.8	2.9	–3.6	10.9

[1]Wilshire index reflects price performance. It differs slightly from market value of outstanding stocks because of retirements of equity since index was created. [2]Based on sales. [3]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable. [4]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

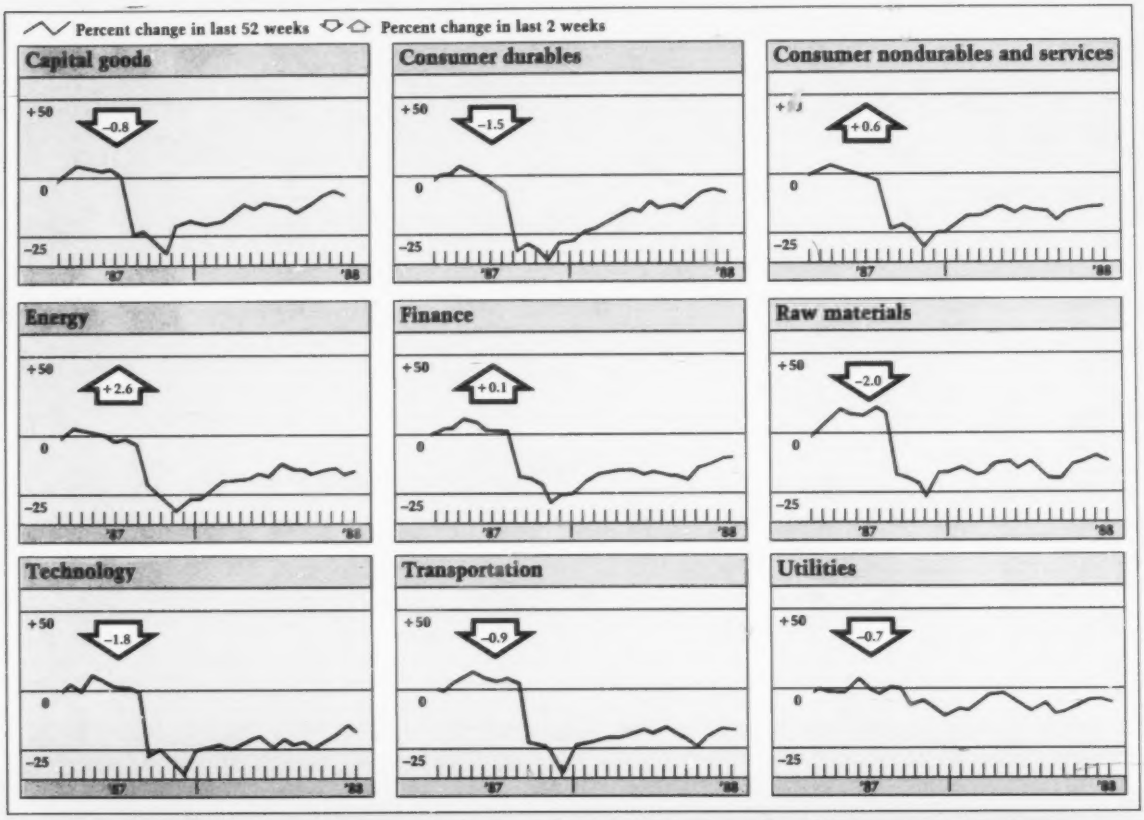
Steven Ramos

Note: All data for periods ending 7/15/88. Prepared by Wilshire Associates, Santa Monica, Calif.

Where the Action Is

Earnings moves. The market may appear to be in the summer doldrums, but certain stocks moved sharply when quarterly earnings were released. For example, Wheeling-Pittsburgh, the eighth-largest U.S. steel producer, reported second-quarter earnings of $7.73 a share, versus $4.10 a year ago. Wheeling, which is in Chapter 11, closed at 24⅛, up 62% for the two-week period.

In contrast, Genentech reported second-quarter earnings that were unchanged from the previous quarter, and the stock dropped 12%, to 24. Genentech, once a Wall Street favorite, has now lost over $3 billion in market value from its 1987 high, while its price-to-sales ratio dropped from 39.5 to 8.6. That doesn't make Genentech a bargain; the market's price-to-sales ratio is 0.73.



What the Analysts Think

Changing perceptions. One year ago the trailing P/E for the Forbes Sales 500 was 19.1. Now it's 14.3. That makes the earnings yield (earnings/price) for the group 7%. The higher 1989 earnings predicted by Wall Street analysts give the Sales 500 an estimated 1989 market multiple of 9.9, for an earnings yield of 10%.

Forecasting the Forbes Sales 500

Performance period	Average earnings per share	P/E
latest 12 months	$2.69	14.3
1988 estimates	3.55	10.9
1989 estimates	3.92	9.9

Rank based on change in estimate	Sector	Estimated 1988 EPS	Estimated 1988 P/E	% change in 1988 estimate in 2 weeks	% change in 1988 estimate in 4 weeks
1	Raw materials	$3.04	10.6	0.66%	1.40%
2	Capital goods	2.59	15.1	0.25	0.20
3	Consumer durables	4.41	11.7	0.16	1.41
4	Utilities	2.40	10.0	0.06	–0.03
5	Technology	2.87	12.3	–0.08	–0.15
6	Energy	3.07	12.4	–0.15	0.31
7	Consumer nondurables	2.48	13.1	–0.24	–0.47
8	Transportation	2.44	11.3	–0.33	–1.42
9	Finance	3.39	8.4	–1.00	–1.46

Earnings projections are capitalization-weighted consensus estimates from over 3,000 security analysts. Data are compiled and updated continually by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York-based brokerage firm.

Note: All data for periods ending 7/15/88. Prepared by Wilshire Associates, Santa Monica, Calif.; IBES, a service of Lynch, Jones & Ryan, New York.